1958

First National City Bank
Monthly Letter

Business and Economic Conditions

New York, November, 1958

General Business Conditions

THE upturn passed the six-month mark during October and business reports have evidenced continuing recovery, even though at a slackened pace. The general expectation is that new peaks in income and gross national product will be reached in the fourth quarter. Retailers are talking confidently of a record Christmas season. The high level of contract awards indicates sustained residential and nonresidential construction activity, and increased automobile production and sales seem assured. An added sign of business improvement is the definite upturn in corporate profits during the third quarter. Industrial purchasing remains cautious; new orders received by manufacturers have been rising, but closely in line with shipments, and backlogs of unfilled orders have leveled off following the steep decline through early spring.

Business indicators showed some hesitancy in September. The Federal Reserve's seasonally adjusted index of production for that month was 137, only one point higher than the revised August index. The United States Department of Commerce estimates that retail sales, seasonally adjusted, were down 2 per cent from August to September. According to limited data available, October output and sales may show only a seasonal rise.

In part, the leveling out of production and sales reflects temporary factors such as strikes and model changes in the automobile industry, as well as, perhaps, a natural adjustment following a period of unusual acceleration. Some people ask whether recent developments are signaling a renewed downturn, but the general view is that they are not. The question now is whether the upturn, tripped off in large part by government spending, can become self-sustaining. To assure full recovery, a sizable revival in both consumer and business demand for durables is needed. While a moderate upturn in these areas is generally expected, few observers look for anything spectacular.

The Pause in Durable Goods

In its early stages, the outstanding characteristic of this recovery was the rapid reversal of the recession – the sharp decline followed immediately by an equally sharp upturn. This V-shaped pattern was conspicuous in industrial production, and particularly in durable goods output. The Federal Reserve index of durable goods production rebounded 10 per cent in the four months from April to August – the same percentage it had declined in the four months preceding the April low. In September, however, the durable goods index was unchanged from August.

Most durable goods industries expanded production in September, notably steel, building materials, furniture and household appliances. A drop of one eighth in output of autos, trucks, and parts neutralized this trend. The decline in auto production reflected the greater concen-

CONTENTS

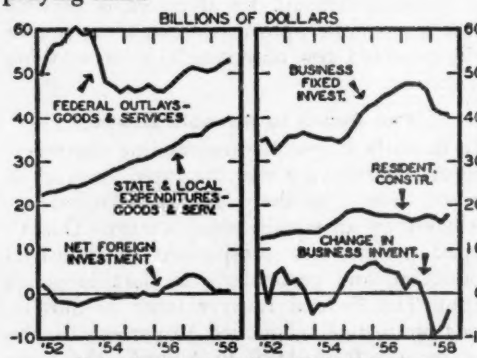
tration of model changeover shutdowns this September than last, and the loss of output through local union walkouts both before and after the industry signed new three-year contracts with the international union. Labor troubles and resulting parts shortages closed some plants for most of October as well, and production of new cars, originally scheduled at 488,000 in October may not have reached 250,000.

The output lost due to strikes in September and October combined was 300,000 new model cars, according to Ward's Reports. Such a loss, just as '59 models were being introduced, aided a rapid cleanup of old model stocks but resulted in thin dealer stocks of new models. Sharply accelerated production is scheduled in November and December as auto manufacturers work to stock their dealers and fill order backlogs.

Forces Behind the Upturn

Official estimates show an impressive rise in the gross national product during the third quarter. The nation's output of goods and services increased from a seasonally adjusted annual rate of $429 billion in the second quarter to $440 billion in the third. Unlike the rise in the second quarter, which was small and largely attributable to higher prices, the $11 billion gain in the third quarter was almost entirely an increase in physical volume.

Major components of the national product during two recessions are shown in the accompanying chart.



Major Components of Gross National Product Other than Consumer Expenditures
(Quarterly at seasonally adjusted annual rates)

It is clear that the major force behind the V-shaped pattern of this recovery was the shift in inventory demand. Compared with the 1954 recession, inventory cuts were deeper and faster; likewise there has been sharper and faster relief from the downward pressure of inventory reduction.

An encouraging feature of the third quarter figures was the apparent end of the decline in business fixed investment. This supports earlier predictions made on the basis of businessmen's plans and anticipations. However, there has been no sign of a surge of new orders or an accumulation of unfilled orders for capital equipment which could form the basis for a rapid upswing in plant and equipment outlays. Order backlogs for machine tools and structural steel were still declining in September.

Capital investment is vital to a broadening of the recovery. We have come through a period of record capital spending which was halted by the emergence of excess capacity. There is no expectation that the boom in capital spending of 1955-57 will be repeated in the immediate future, but some upturn may develop next year. As in 1958, the emphasis will continue to be on replacement and modernization, particularly where labor saving and other cost cutting are involved.

The resurgence of home building, first evident in the number of new homes started last spring, was reflected in increased third quarter expenditures on residential construction. Housing starts continued to rise through September, with those privately financed reaching a seasonally adjusted annual rate of 1,220,000 – the highest in three years. As work proceeds on these projects, residential construction outlays will be sustained, although pressures on the capital market developing from government deficit financing may put a brake on further expansion.

As to a fourth major component – government spending – continuing increase lies in prospect. The current rising trend of federal outlays for goods and services stands in sharp contrast to the 1954 recession. At that time budget retrenchment and the termination of the Korean War were causes of the business downturn, and general tax reductions were the stimulant that hurried recovery and led into three years of boom. The steady upward trend of State and local expenditures, which helped to cushion both recessions, shows no signs of leveling off, though, of course, it means ever higher taxes as well as continuous pressures on the capital market for borrowed money.

On balance, these important areas of the economy show considerable strength for the months ahead. They are commonly regarded as having an important influence on volume of personal income. A chief remaining question in the business outlook is what the consumers will do with their rising incomes.

What Will the Consumer Do?

Consumer spending on nondurable goods and services rose to new records in the third quarter.

Durable goods spending also increased for the first time in a year. There has been evidence of reviving demand for appliances and other major household items, but over-all demand for consumer durables has lagged. Whether the auto business will swing out of its doldrums is still to be seen. The real test of whether Americans are in a spending mood will come after passenger cars are once more in ample supply.

When sizing up the prospects for increased consumer spending for durables, there is little doubt that the economic climate is improved. Employment has increased, more normal working hours have been restored, and fears of being laid off have diminished. Payroll envelopes are fatter, consumer debt has been worked down, and savings fortified. With respect to the strategic automobile industry, owners of the record number of 1955 models may decide it is time to trade. The trend toward suburbanization and the two-car family is continuing. If consumers like what they see in styling, find prices acceptable, and are in a buying mood, the auto industry should become a stronger supporting factor in the year ahead.

Recovery in Corporate Earnings

The upswing in business which started in the spring has had a marked effect on corporate profits. Corporate reports issued during the past month show an increase of over one sixth in net earnings after taxes between the second and third quarters. This advance is particularly significant because more often than not in recent years profits have declined during the third quarter. In the latest quarter, increased sales volume and tightening up on efficiency are yielding benefits in better profit margins.

This bank's tabulation covers over 700 corporations with third quarter earnings of over $2.8 billion. In the last few years, this group has accounted for more than half of the profits of all corporations as estimated by the U.S. Department of Commerce. The over-all gain of 17 per cent from the second to the third quarter was shared by 20 of the 22 major industries covered. Despite considerable variation in the experience of individual companies, nearly two thirds of the corporate reports showed third quarter net income above the second quarter rate.

The third quarter improvement in earnings was not sufficient to offset the cumulative decline of the preceding three quarters. Third quarter 1958 earnings were 6 per cent lower than a year earlier. The total for the first three quarters of 1958 was down 23 per cent from the corresponding 1957 period.

Highlights of this survey are shown in the following condensed table. The larger table on the next page presents more detailed information for major industry groups.

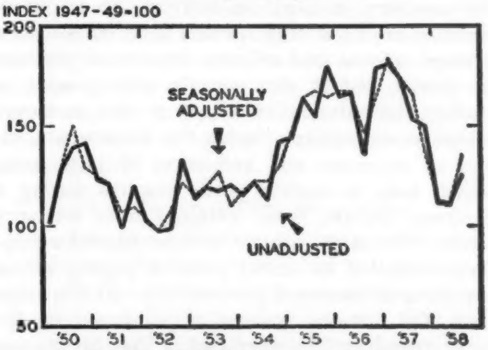
Condensed Summary of Profits Changes

	Manufacturing	Other	Total
Per cent change in profits			
3rd Quarter '58 vs. 2nd Quarter '58	+14	+27	+17
3rd Quarter '58 vs. 3rd Quarter '57	—13	+15	— 6
9 months '58 vs. 9 months '57	—29	— 5	—23
Number of companies	525	183	708
Number with increased profits			
3rd Quarter '58 vs. 2nd Quarter '58	334	122	456
3rd Quarter '58 vs. 3rd Quarter '57	250	105	355
9 months '58 vs. 9 months '57	173	84	257
Per cent with increased profits			
3rd Quarter '58 vs. 2nd Quarter '58	64	67	64
3rd Quarter '58 vs. 3rd Quarter '57	48	57	50
9 months '58 vs. 9 months '57	33	46	36

Manufacturing Profits Advance

Third quarter earnings reports for 525 manufacturing corporations showed an over-all increase of 14 per cent over the second quarter. This change, which, of course, is measured from a depressed level, is the greatest gain for any third quarter in the past 12 years. Over the past decade, the tendency has been for profits to dip between the second and third quarters with a median seasonal decline of about 7 per cent. Thus, on a seasonally adjusted basis, profits in the third quarter were up roughly 22 per cent from their low in the preceding quarter.

In order to increase the usefulness of this bank's corporate earnings tabulations, the quarter-to-quarter changes in net income after taxes of leading manufacturing corporations were linked together into an index number, with the 1947-49 average equaling 100. This index, with and without adjustment for seasonal fluctuations, is shown in the accompanying chart.



Net Income of U.S. Manufacturing Corporations
Based on First National City Bank tabulations, 1947-49 — 100

These figures provide an indication of the trend in corporate profits and are published one month after the end of each quarter. They are available about six weeks earlier than the more comprehensive Securities Exchange Commission-

NET INCOME OF LEADING CORPORATIONS FOR THE FIRST NINE MONTHS AND THIRD QUARTER
(In Millions of Dollars)

No. of Cos.	Industry Groups	Reported Net Income Third Qr. 1957	Second Qr. 1958	Third Qr. 1958	% Change from Third Qr. 1957	Second Qr. 1958	Reported Net Income Nine Months 1957	1958	Per Cent Change
40	Food products and beverages	$ 81.8	$ 81.5	$ 82.3	+ 1	+ 1	$ 241.5	$ 238.3	— 1
10	Tobacco products	36.8	40.6	44.9	+22	+10	93.9	119.7	+27
28	Textiles and apparel	17.1	12.1	20.1	+18	+66	57.6	43.4	—25
9	Tires, rubber products	19.5	15.9	19.2	— 1	+21	61.8	47.6	—23
28	Paper and allied products	40.9	36.7	39.9	— 3	+ 9	127.2	110.9	—13
34	Chemical products	212.3	171.0	182.3	—14	+ 7	661.1	506.1	—23
23	Drugs, soaps, cosmetics	78.2	65.1	78.6	+ 1	+21	209.5	216.9	+ 4
23	Petroleum prod. and refining	433.7	294.5	429.6	— 1	+46	1,477.6	1,088.8	—26
49	Cement, glass, and stone	95.0	82.3	105.1	+11	+28	262.8	229.9	—13
32	Iron and steel	206.8	145.0	153.7	—26	+ 6	734.4	403.8	—45
27	Electrical equip., radio & tv	109.4	89.3	112.5	+ 3	+26	348.4	285.5	—18
43	Machinery	66.5	64.1	78.8	+19	+23	217.4	191.3	—12
39	Other metal products	159.3	116.5	147.4	— 7	+27	501.5	371.4	—26
25	Automobiles and parts	203.0	123.9	22.7	—89	—82	988.8	346.6	—65
20	Other transportation equip.	33.8	26.8	23.8	—30	—11	114.4	82.4	—28
45	Misc. manufacturing	75.7	65.1	85.0	+12	+30	207.3	199.9	— 4
525	Total manufacturing	$1,870.3	$1,430.5	$1,626.2	—13	+14	$6,304.7	$4,482.5	—29
21	Mining and quarrying	28.8	20.9	21.3	—26	+ 2	107.6	66.7	—38
29	Trade (retail and wholesale)	34.5	32.5	34.7	+—†	+ 7	95.8	97.4	+ 2
14	Service & amusement indus.	9.2	8.3	8.7	— 5	+ 5	25.1	24.2	— 3
54	Railroads	155.4	76.2	192.7	+24	+—†	445.3	288.8	—35
61	Electric power, gas, etc.	148.8	159.7	163.3	+10	+ 2	481.9	526.5	+ 9
4	Telephone and telegraph	219.6	248.6	265.5	+21	+ 9	666.5	732.3	+10
708	Total	$2,466.6	$1,971.8	$2,312.5	— 6	+17	$8,126.9	$6,218.4	—23

Per cent changes and totals computed from unrounded data. † Increases or decreases of under 1% or over 100% not shown.

Federal Trade Commission data on earnings of all manufacturing corporations and nearly three months earlier than the Department of Commerce estimates of profits of all corporations.

The seasonally adjusted series facilitates comparisons between quarters, since adjustments have been made for the tendency of profits to rise in the fourth quarter and to decline in the first and third quarters. On a seasonally adjusted basis, it appears that the recent rise in net earnings recovered fully a third of the decline between the first quarter of 1957 and the second quarter of 1958.

Better Earnings Through Improved Efficiency

The basic reason behind the rise in profits is the recovery in business activity. An improvement in sales not only spreads fixed costs over a greater volume and relieves downward pressure on prices, but it also permits management to realize the cumulative effect of the economy measures undertaken during the downturn. Control of expenses and reduction of unit costs, which help to sustain profit margins during a business decline, boost earnings once recovery starts. The large volume of new capital equipment installed in recent years is paying off in the form of increased productivity. At the same time, the reduced volume of plant and equipment spending this year means that profits are less often being reduced by the expensive process of breaking in new facilities.

The upturn in corporate profits is especially welcome to the U.S. Treasury for the benefit it promises to offer to the revenues. Meanwhile, however, it should be noted that tax-loss carry-backs — at the cost of the Treasury — may have played a significant role in limiting the declines in aggregate reported profits after tax during the recession. A number of major companies, suffering heavy losses, became entitled to recapture large sums from taxes paid in previous boom years.

Greater industrial efficiency arising from new equipment, improved operating methods, and elimination of wasteful and inefficient practices has made possible reductions in the work force. Numerous firms have found that not all workers laid off need to be rehired. This tendency has persisted throughout the postwar period, but is most noticeable in the early stages of recovery. Following the 1954 recession, industrial production soon regained and exceeded its 1953 peak, but factory employment recovered less than two thirds of the cutback experienced during the downturn, many of these workers filling expanding job opportunities in trade, services, and other lines. Recently, production has been rising much faster than employment, bringing savings in payroll costs.

A Broad Upturn

For most industries, earnings in the third quarter were the best so far this year. In manufacturing, the largest gains in net income between the second and third quarters were scored by textiles and apparel and the petroleum industry, each of which had had sizable declines in the first and second quarters. The cement, glass, and stone group boosted earnings 28 per cent, benefiting from the heavy construction boom and from the revival in home building. Third quarter profits of the machinery industry rose nearly one

fourth after a disappointing first half, partly because of increased defense business and partly because of demand for cost-cutting and labor-saving equipment.

The iron and steel industry had only slightly higher earnings despite a rising rate of operations during the third quarter. The rise in labor costs, effective July 1, was not offset by higher prices until after August 1. One steel company estimated that only 58 per cent of its third quarter shipments carried the higher price tags, while other industry officials claimed the price rise was "inadequate" to cover the increase in costs. Automobile manufacturers found their third quarter profits curtailed (or losses increased) not only by substantially lower sales levels and wildcat strikes but also by the generally earlier introduction dates for new models, which threw a larger share of the heavy changeover expenses into the third quarter this year.

Despite substantial improvement in the third quarter, earnings in the first nine months still lagged behind 1957 in most lines. Among manufacturing industries, only the tobacco and drugs-soaps-cosmetics groups showed year-to-year gains for the three quarters. In the nonmanufacturing group, mining, services, and railroads had lower net income. Trade, utilities, and communications, however, reported higher net profits in both the third quarter and the nine months' than they did in the same periods last year.

The general business recovery was a major influence in the rise of sales during the third quarter. In many cases, this advance was aided by intensified selling efforts and the promotion of new products. Nevertheless, for the first nine months sales of manufacturing corporations included in the survey were down 12 per cent from the corresponding 1957 period. Net earnings fell much more than this, because profit margin per sales dollar declined from 6.6 cents in the first nine months of 1957 to 5.2 cents in the 1958 period. Many firms, however, reported that profit margins improved in the third quarter. Cost cutting enabled some firms to maintain or improve earnings despite lower sales.

Dividends Holding Up

According to the *New York World-Telegram & Sun's* monthly dividend tabulation, fewer extra dividends were declared in the third quarter than in the corresponding quarter of 1957. However, in contrast to the first half of 1958, favorable actions on regular dividends (increases and resumptions) were practically as numerous as unfavorable actions (omissions and reductions).

The figures of the United States Department of Commerce on publicly reported cash dividend payments for the first nine months show only a slight reduction from the same period in 1957.

The $12 Billion Problem

During October the Treasury covered its immediate cash requirements by the sale of $2.7 billion 3¾ per cent special Treasury bills due May 15, 1959 and $1.2 billion 13-month notes due November 15, 1959. With $3.6 billion borrowed in August on tax anticipation certificates due next March, and $800 million obtained in recent weeks by adding $100 million to each of eight issues of 91-day Treasury bills, the Treasury has raised $8.3 billion through cash sales of marketable securities since July 1, the beginning of the 1959 fiscal year.

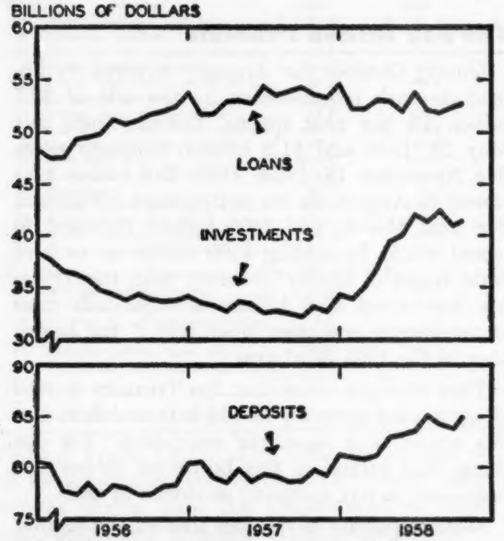
Thus it might seem that the Treasury is well along toward covering its $12 billion deficit. But this would be a superficial conclusion. For one thing, $2.8 billion of this borrowed money has been used to pay maturing securities in cash.

More important is the fact that all the regular marketable securities sold since July 1 will fall due and have to be refinanced before the close of the calendar year 1959. Thus "permanent" financing of the deficit has been postponed. Since short-term obligations also were used to refund more than $13 billion obligations which came due in August and September, the volume of marketable Treasury securities requiring refinancing during the 1959 calendar year (excluding regular 91-day Treasury bills) has been increased from $16.9 billion as it stood on June 30 to $37.9 billion as of October 31. Furthermore, it seems almost certain at this date that the volume of securities requiring refinancing during 1959 will be increased still more as the Treasury seeks to raise additional billions to meet its commitments. Plans are now forming to raise $3 billion in November and the prospect is for cash offerings or refundings every month or two from then on to the end of 1959 or beyond.

Where the Securities Have Gone

It is generally held that short-term financing is inflationary because short-dated securities are most apt to be purchased by commercial banks with effects of increasing deposits and thus the "money supply." Despite the multi-billion increase in short-term Treasury indebtedness since July, however, neither bank deposits nor bank holdings of government securities have increased significantly. For the weekly reporting member banks, as shown on the chart, total security holdings (of which U.S. issues are most important)

were only $10 million higher on October 22 than on July 30. Deposits (leaving aside U.S. and interbank categories) were actually down $112 million.



Weekly Reporting Member Bank Loans (excluding loans to banks), Investments, and Deposits (excluding interbank and U.S. Government)

(Last Wednesday of each month, latest plotting October 22)

Contrary to many impressions, the main market for short-term securities today is outside the banks, among corporations and other holders of liquid funds. As of July 31, for example, there were $67.8 billion marketable government securities due within one year, of which $22.9 billion were held by Federal Reserve Banks and U.S. Government trust funds. Of the remaining $44.9 billion of public holdings less than one third were held by commercial banks. The following table shows how the proportion of bank holdings of government securities bulks up in the 1-5 and 5-10 year maturity ranges. The smallest bank participation is, of course, at the long end.

Distribution of Privately Held Marketable Public Debt By Maturity, as of July 31, 1958

(Dollar figures in millions)

	Total Privately Held*	Held by Com'l. Banks	% Held by Com'l. Banks
Treasury bills (due within 91 days)	$ 20,653	$ 3,886	18.8%
Certificates (due within 1 year)	12,374	3,307	26.7
Notes & bonds due within 1 year	11,863	6,132	51.7
Notes & bonds due in 1-5 years	38,541	24,673	64.0
Bonds due in 5-10 years	21,575	14,223	65.9
Bonds due in 10-20 years	23,508	4,646	19.8
Bonds due in over 20 years	6,650	524	7.9
Total	$135,164	$57,391	42.5%

*Excludes holdings of Federal Reserve Banks and U.S. Government investment accounts.

Source: U.S. Treasury Survey of Ownership.

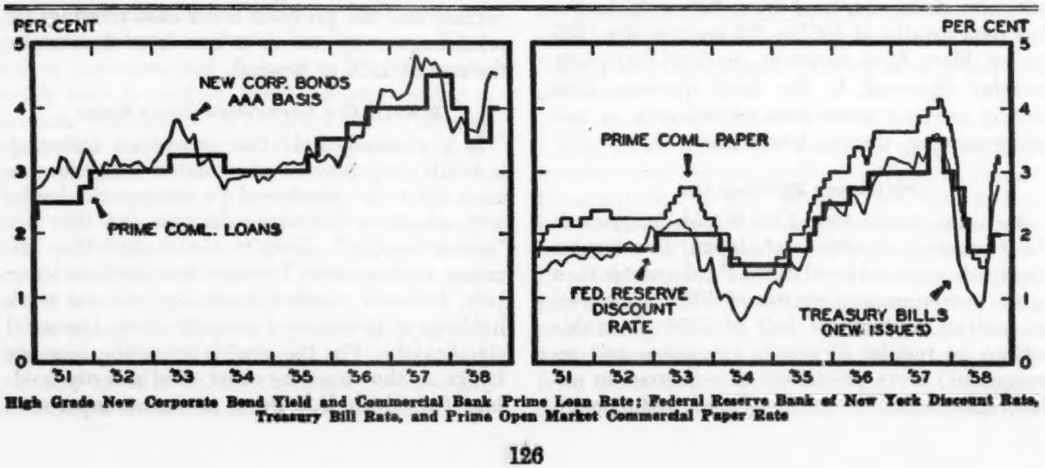
The fact is that, when Federal Reserve policies are addressed to restraining inflation, short-term securities such as those offered in August and October tend to gravitate into the hands of corporations and other nonbank short-term investors.

The redistribution of new Treasury security issues to nonbank buyers would not have occurred if the Federal Reserve had been concerned to hold down money rates. The nonbank market would not have opened up and banks (including the Federal Reserve itself) would have held the additional securities.

A Classic Illustration

Thus we have a classic illustration of how a restrictive credit policy, producing higher money rates, can hold down bank deposits and earning assets in the face of Treasury deficit financing. What happened was that the banks initially took on the bulk of the new securities as underwriters. Pressures on their reserves forced them to sell off the securities as quickly as buyers could be found.

With the Federal Reserve discount rates at 2 per cent, and yields on short-term Treasuries in the range of 2½ to 3½ per cent in early October, a temptation was offered for banks to borrow from the Federal Reserve and defer selling



High Grade New Corporate Bond Yield and Commercial Bank Prime Loan Rate; Federal Reserve Bank of New York Discount Rate, Treasury Bill Rate, and Prime Open Market Commercial Paper Rate

the newly-issued Treasury obligations. This temptation was reduced October 24 when the Reserve Banks began a sequence of discount rate increases to 2½ per cent. If banks should show a tendency to take on too many government securities, to be carried against borrowings, the rate can be further advanced without notice. But with successive additional offerings in prospect, banks in any case need to break money loose to participate in future underwritings.

It has required sharply increased money rates to adequately broaden the nonbank market for U.S. securities. Yields on 91-day Treasury bills, for example, rose from an average below 1 per cent in July to above 2¾ per cent in October. Presumably, these yields would rise much further if the Treasury were to attempt to do the whole deficit-financing job at short term outside the banks.

The technical success of Treasury deficit financing so far should not blind us to the fact that, even though redistribution outside the banks is accomplished, short-term finance involves an inflationary process. Short-dated securities are bought and paid for out of cash reserves which then enter active circulation when the Treasury spends the proceeds. The holder meanwhile still has a liquid asset, an undeniable claim upon the Treasury for future money. An excessive floating debt creates practical problems not only for the Treasury in meeting debt maturities, but also for the Federal Reserve in exercising restraint on spending.

Bond Financing

The pitfalls of floating debt finance are well recognized. The best place for permanent debt is at long term with investors who want stable and assured income on their funds. Favorable opportunities to place long-term securities have been passed by time and again in the postwar period, either because the Treasury was unwilling to meet the market and pay the required rate or because it was desired to give priority to home builders and other long-term borrowers. But the U.S. must hold a place as a periodic borrower in the bond market if the debt is to be soundly constructed.

The recent background for bond financing has not been auspicious. U.S. bond prices were driven up out of touch with broad investment interest in June. For the following three months U.S. bonds declined almost continuously, reflecting speculative unloading, the swollen federal deficit and withdrawal of the Federal Reserve's easy money policy, as well as unexpectedly heavy claims upon the capital market from home builders, industry, and State and local governments. The $12 billion deficit, contributing strongly to inflationary psychology, meanwhile led many investors to shift investment preferences away from bonds toward stocks. Mutual fund sales, for example, never were so large as this past summer and this at the precise time when the Federal Government needed and wanted many more buyers for its bonds.

Encouragingly, people at the same time have continued to add to their savings accounts and life insurance protections at a rate beyond $15 billion a year, but this money has scarcely been enough to fill the wants of builders for mortgage money and absorb bond issues put out by corporations, states and municipalities, foreign borrowers, and federal agencies. There has not been much room within the loan and investment programs of savings institutions for more U.S. securities.

Treasury officials in recent weeks have stressed the need to place more of the debt at long term. In successive public speeches they have been urging particularly life insurance companies, mutual savings banks, and other institutional investors to purchase more Treasury bonds and thus assist in combating inflationary pressures.

These savings institutions, of course, have their own problems. They must realize the best rates they can with safety so that they can in turn offer a better deal to their customers and, in the public interest, sustain the savings flow. Until the last few weeks, yields available in the market on U.S. bonds were hardly sufficient to support the rates of interest paid by savings banks. During October, as yields on U.S. bonds approached a 4 per cent level, investment interest appeared with the effect of steadying out the market. Fortuitously, business credit demands lightened. This gives encouragement to the idea that there would be a considerable buying interest in government bonds at a 4 per cent interest rate level. Four per cent is the rate the Treasury offered on 12-year bonds sold in October 1957 without seriously injurious effects upon the supply of funds available for mortgage investment. Whether enough could be raised to make the effort worth while is difficult to answer. But it will be impossible to find out without trying.

The Real Trouble

The Treasury Department seized opportunities to put out longer-dated bonds during the fiscal year ended June 30, 1958, placing in the market, at rates ranging from 3¼ to 4 per cent, $4.2 billion bonds due beyond 10 years. This was more than the deficit experienced in fiscal '58 and the first step forward in debt reconstruction

since 1955. Now the deficit is quadrupled, $12 billion as compared to $3 billion, while the visible demand for U.S. bonds is conspicuously weakened. The trouble is with the size of federal spending and the deficit, which has sent the national debt into new high ground beyond the peaks of World War II and is frightening many potential buyers into inflation hedges. Ironically, more bonds could be sold if deficit-financing requirements were more modest.

The real attack must be upon government expenditures. The upturn in business will help in bolstering revenues, but it must be joined with a determination to hold outlays in check and rebalance the budget at the earliest possible date.

International Currency Proposals

During recent months there have emerged several proposals for dealing with the problem of "international liquidity" and for helping the less developed countries build output and living standards. Fresh attention has been given to schemes to moderate fluctuations in prices of various internationally traded key commodities, coffee and metals in particular, so that the primary producing nations might have steadier income from exports. The most concrete proposals, however, would enlarge supplies of money available to help nations experiencing financial strains.

The curtain opened in the last days of August when President Eisenhower gave the go-ahead signal to Secretary of the Treasury Robert B. Anderson to concur in the plans to increase the resources of the International Monetary Fund and World Bank as well as to propose a new International Development Association as another affiliate of the World Bank. In September, the United States came forward with a suggestion for an Arab development bank and endorsed plans for an Inter-American development fund. The United States already has in operation many programs of its own, including most importantly the Development Loan Fund established in 1957, the Export-Import Bank with greatly enlarged loan resources, as well as the sale of farm surplus commodities in exchange for foreign currencies.

Meanwhile, at Montreal a conference of the British Commonwealth nations welcomed the United States' support for a larger Fund and Bank. The conference stressed the great importance of more rapid economic progress, but deferred a decision on the proposal to set up a Commonwealth development bank.

In the early part of October the finance ministers and central bank presidents of 69 member nations gathered in New Delhi for the thirteenth annual meetings of the International Monetary Fund and the International Bank for Reconstruction and Development, and for the second meeting of the International Finance Corporation. The idea of providing the Fund and the Bank with larger resources was endorsed in principle. It was suggested by the United Kingdom that the increase should amount to 50 per cent for the Fund and 100 per cent for the Bank, though this question was left for the directors of the two institutions to study and to report on in December. The plans will have to be referred to the various governments, which must prepare the necessary bills and pilot them through legislatures.

Fund's Business and Liquidity

From 1947 to the end of September 1958, the Fund's operations came to $4 billion. Some $3.2 billion represented actual exchange transactions and $800 million unused stand-by arrangements under which the beneficiary can draw during a specified period of time. Of the $3.2 billion of exchange transactions, more than half were made in late 1956 and during 1957, embracing the period of the Suez crisis and of the world-wide inflationary boom.

IMF Transactions and Gold and U.S. Dollar Holdings
(In Millions of Dollars)

Year Ended Dec. 31	Currencies Taken U.S. Dollars	Currencies Taken Other	U.S. Dollars Repaid	U.S. Dollar Holdings	Gold Holdings
1947	462	6	6	1,598	1,356
1948	197	11	11	1,391	1,436
1949	102	—	2	1,289	1,451
1950	—	—	24	1,305	1,495
1951	7	28	74	1,324	1,530
1952	85	—	102	1,288	1,692
1953	68	162	321	1,383	1,701
1954	62	—	210	1,565	1,787
1955	28	—	232	1,706	1,808
1956	678	15	113	1,142	1,892
1957	977	—	64	775	1,380
1958*	197	68	110	664	1,442
Total	2,860	291	1,268		

*Seven months ended July 31. Source: International Monetary Fund.

During the past year, a number of countries in Central America borrowed to meet seasonal drains on their gold and foreign exchange reserves. Others sought Fund assistance to help carry out financial stabilization and rehabilitation programs — among them Brazil, Chile, France, and Turkey. Still others drew on the Fund in order to support, in the face of what they regarded as temporary foreign exchange stringencies, policies of trade and payments liberalization that they had adopted previously. Denmark, Japan, and the Netherlands used the Fund for this reason in 1957 while taking appropriate measures to restrain internal demand and thus relieve excessive importing. This year, Denmark, Japan, and the Netherlands repaid sizable portions of these drawings, and the Netherlands

canceled an unused line of credit six months before it expired. The United Kingdom, which had drawn from the Fund $561 million toward the end of 1956 amidst a severe sterling crisis, announced at the New Delhi meeting that it would discuss with the Fund the timing and arrangements for repayment.

As can be seen in the table, the currency most widely sought from the Fund has been U.S. dollars. On some occasions the Fund has sold moderate amounts of other currencies; this year, such drawings consisted of German marks, Dutch guilders, and sterling.

Repayments, which can be made only in gold or U.S. dollars, had by the end of September 1958 amounted to $1.4 billion. All exchange sold by the Fund prior to May 1952 has been repurchased. Since the sales in the last three years were made for periods ranging from 3 to 5 years at most, the Fund should receive substantial amounts of gold and dollars beginning in late 1959 and in 1960.

At the end of September 1958, the Fund held $2.2 billion of gold and U.S. dollars. If allowance is made for the contingent liability represented by unused stand-by arrangements, the Fund had an uncommitted balance of $1.3 billion in gold and U.S. dollars.

Repayments and cancellations of unused credit lines reinforce, of course, the Fund's liquidity. Strengthened demands for other currencies held – such as German marks, Dutch guilders, and sterling – make the institution more of a general revolving fund. The IMF's Managing Director, Dr. Per Jacobsson, indicated at the New Delhi meeting that a study is being made of the possibility of allowing countries drawing non-convertible currencies from the Fund to repay it in such currencies, and not in gold or dollars, as heretofore. This could make such other currencies held by the Fund more acceptable.

The Fund's resources for supporting nations under financial strain have been powerfully aided by credit facilities available outside the Fund. The help given by the Fund earlier this year to countries like Brazil, France, and Turkey was thus accompanied by additional credits from the U.S. Government, American commercial banks (Brazil), and the European Payments Union (France, Turkey). As is pointed out in the Fund's annual report, "the availability of such additional international liquidity from sources other than the Fund is clearly relevant to any discussion of the adequacy of the Fund's resources."

Enlarging the Fund's Resources

The dominant topic of discussion at New Delhi was naturally the question of enlarging the Fund's resources by an increase in the member countries' quotas. The need for such an increase had been acknowledged early in September in a technical report by the Fund's staff on "International Reserves and Liquidity." The report disputed the existence of a serious general shortage of international reserves but concluded: "It is doubtful whether, in the circumstances of the world today, with world trade greatly expanded in volume and value, the Fund's resources are sufficient to enable it fully to perform its duties."

The increase is advocated principally on the ground that a great deal has happened in world trade and payments since the resources available to the Fund were fixed in 1944. By 1957, the physical volume of world exports was 60 per cent higher than in 1937 and prices of goods moving in international trade increased by 140 per cent. As the Managing Director noted, "the result of the price rise has been that, in real terms, the Fund's resources are now considerably less than was envisaged when its original endowment was made."

The circumstances in which the Fund may be called into action cannot, of course, be defined in advance. "The only thing that one can reasonably state," the Fund's Managing Director said, "is that in any emergency or even in any period of exchange tension, the movements of funds that will follow are likely to be on a large scale," as actually happened in 1956 and 1957. In a period of acute tension, extensive drawings on the Fund may, therefore, be sought by several countries at the same time, and it is important that the Fund be able to make its resources available on a large scale. Dr. Jacobsson noted that it is by putting the Fund's resources "to use where they are most needed to prevent a crack" that the most valuable results are likely to be secured. He emphasized:

> Experience has shown (as was learned very forcibly in 1931) that once a crack starts it is difficult to limit its effect. It may lead to a series of forced devaluations of both minor and major currencies – devaluations not dictated by the realities of foreign trade and competitive prices.

A 50 per cent increase in the Fund's quotas would be calculated to add about $2 billion to the Fund's holdings of gold and U.S. dollars. The new U.S. contribution would be $1,375 million, of which 25 per cent or $344 million would be payable in gold. Lacking in other resources, the United States would have to cover this sum out of next year's budget, already threatening to burst its seams.

Other countries would be called to contribute up to 25 per cent of their added quotas in gold, which would bring in a further $500 to $600 million. In addition to gold and U.S. dollars, the Fund would also receive the equivalent of around $900 million in Belgian francs, Canadian dollars, German marks, Dutch guilders, and pounds sterling.

Rapid Expansion in World Bank's Lending

In contrast to the operations of the Fund, which naturally vary from one year to another, the other Bretton Woods twin – the International Bank for Reconstruction and Development – has steadily enlarged its lending. During the fiscal year ended June 1958, new loans amounted to $711 million, as compared with some $400 million annually during the previous three years. And lending continues to increase: during the three months to the end of September new loans amounted to $380 million. As the Bank's President, Eugene Black, noted, membership has grown, but above all the Bank is getting an increasing number of "adequately prepared" bankable applications.

The Bank was able to cover almost all its lending by sales of bonds to investors – $650 million during the year ended June 1958, the highest figure ever recorded in a single year. The bulk was raised in the United States market from American as well as other investors. The Bank also borrowed from the German central bank. Furthermore, it sold participations in its loans to private investors and joined in investment operations with the New York market that involved flotations of borrowers' own bonds simultaneously with the signing of agreements for World Bank loans.

Another source of funds was the release by member countries of a further $149 million from the 18 per cent portion of their capital subscriptions that had been paid in local currencies (the first 2 per cent had been paid in gold or dollars, and the remaining 80 per cent are subject to call, in effect, to cover losses). But the 18 per cent portions can be released by the Bank for lending only with the country's consent. "I would be remiss in my duty," Mr. Black said, "if I did not point out that some half a billion dollars' equivalent in 18 per cent capital is still too hedged about with restrictions to be of any use to us." As the years go by, the Bank is needing and using more and more currencies other than dollars since a large proportion of disbursements (35 per cent during the year ended June 1958) is made in such currencies.

The Rise in the Bank's Capitalization

The Bank, according to Mr. Black, is now approaching a situation where it may be getting a larger number of meritorious applications than it can find money for "on reasonable terms." The investor in World Bank bonds is conscious of the fact that the uncalled 80 per cent of the capital subscribed by the United States, which amounts to $2.5 billion, constitutes, in effect, a U.S. guarantee for Bank obligations up to this amount. The Bank's funded debt, on the other hand, stood last June at $1.7 billion; should it continue to increase at last year's rate of over $600 million, it would reach a $2.5 billion figure in about a year and a half.

It is because the American guarantee is such an important element in the marketability of the Bank's bonds that a 100 per cent increase in the Bank's capital has been proposed. Whether this would involve an additional cash contribution or solely a rise in the uncalled portion of the capital is not yet clear; the United Kingdom's spokesman expressed the hope that "the Bank's operations would be so managed that the additional capital would all remain uncalled."

Attitudes of the Principal Foreign Countries

At the New Delhi meetings, all countries endorsed the increase in the Fund and Bank resources but there were marked differences of opinion about the necessity of these moves. Among the Continental Western European countries that would have to contribute usable currencies to the Fund, Belgium and the Netherlands gave a rather lukewarm reception to the proposal of raising the quotas. Germany's Minister for Economic Affairs, Dr. Ludwig Erhard, indicated his country's willingness to make an "appropriate contribution within its possibilities." These three countries have supplied, through the European Payments Union, sizable amounts of their currencies to other countries of Western Europe, chiefly France and the United Kingdom.

Any strengthening of the Fund would be to the advantage of sterling. The rise in the United Kingdom's quota would provide an enlarged second line of defense to support the gold and dollar reserves of the sterling area.

Referring to the recent strengthening of sterling, the British Chancellor of the Exchequer, Derick Heathcoat Amory, stated at the Fund meeting that this had "brought us still nearer to convertibility of the pound, which is our objective." The United Kingdom is running this year the largest payments surplus since the end of the war. Its gold and dollar reserves have continued to rise throughout recent months, normally a

difficult period, and the favorable months now lie ahead. "When we judge that the necessary conditions have been achieved and we can do so without risk, we shall move forward," added the Chancellor. Actually, the United Kingdom removed last September restrictions on another wide range of imports from the United States and Canada and announced that dollar discrimination would be reduced further and ended as soon as possible. This new step of trade liberalization represents a dividend from the successful defense of the pound last year.

The volume of Britain's commitments to supply development capital is, however, unlikely to be increased. As the Chancellor pointed out at the Montreal conference, Britain intends to "maintain and if possible improve on" the recent rate of investment in the Commonwealth, but "we must always be quite sure that we do not accept commitments beyond the limit of our resources."

The countries of Western Europe did not support the United States' idea of an International Development Association – a proposed affiliate of the World Bank that would lend at lower rates and accept soft currencies as well as hard in repayment of its loans. The World Bank already has one affiliate, the International Finance Corporation, intended to provide capital for smaller industrial projects in cooperation with private investors.

The Union of South Africa and Australia were disappointed that the proposals regarding the Fund were restricted to an increase in quotas and pressed once again for a rise in the price of gold. Secretary of the Treasury Anderson restated the American position that "the price of gold in U.S. dollars should remain unchanged."

Some concern was expressed that the Fund, in advising countries on appropriate financial policies, was interfering in their internal affairs. The Fund's Managing Director met these and other criticisms in his closing speech and emphasized once again that for underdeveloped countries, as for others, it was necessary in asking for help to provide "proper justification" and to commit themselves to policies that would hold out the hope of stability "at realistic exchange rates." As Dr. Jacobsson pointed out in giving the reasons for an increase in the Fund's resources, the Fund is not just an additional source of credit but "is recognized more and more as a source of credit that is available in substantial amounts only to member governments that have satisfied the Fund of their intention and capacity to restore balance."

Implications for the United States

President Eisenhower's message, read by Secretary Anderson at the New Delhi meetings, stressed that there is general agreement on the effectiveness of the two institutions:

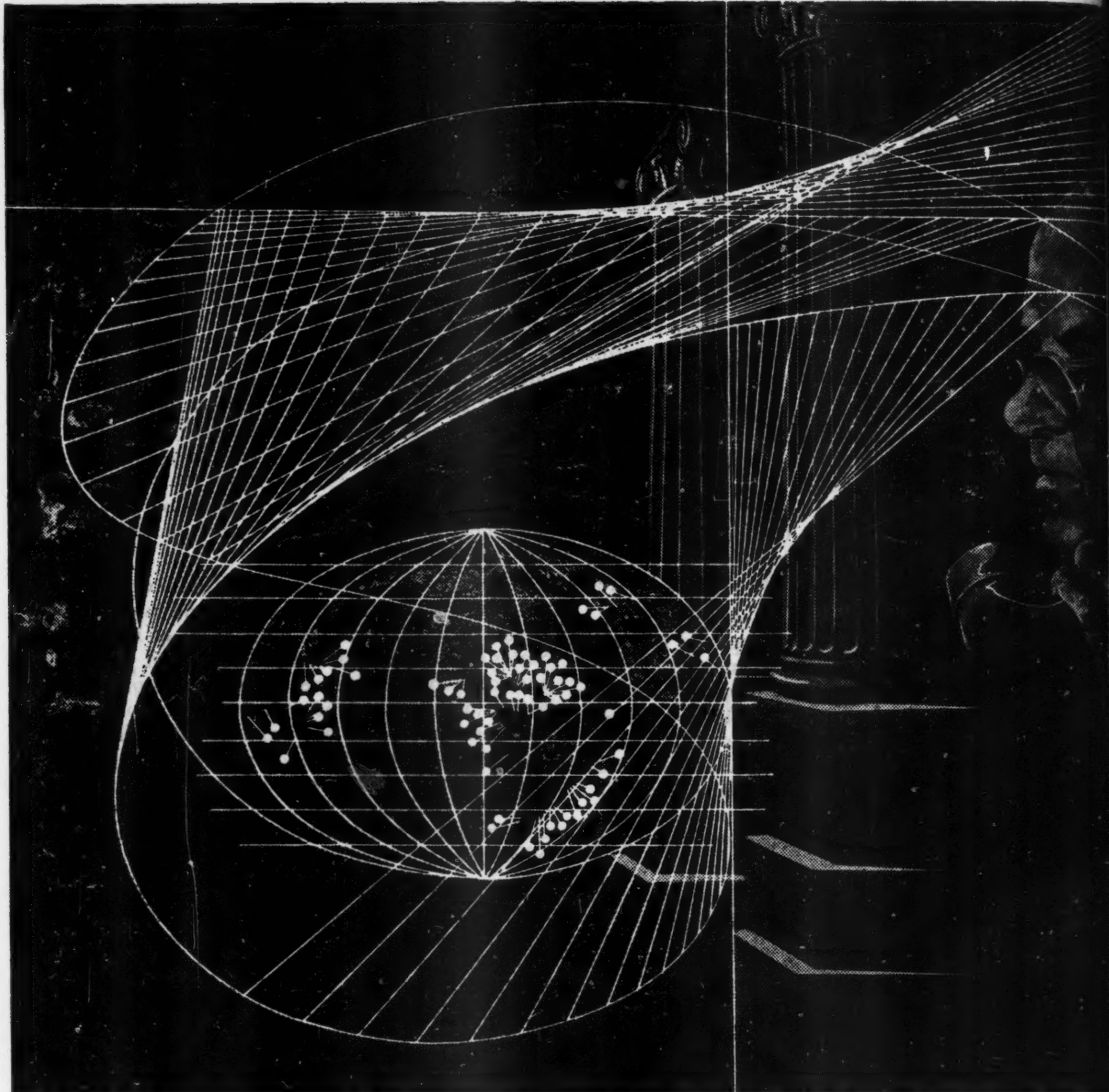
> . . . A constructive increase in their resources would greatly enhance their usefulness to the free world community. . . . It is my conviction that through these institutions we can give real encouragement and hope to all our member countries in the decade ahead. . . .

It remains to be seen whether the new Congress, meeting next January and facing a difficult budget situation, will accede to making further contributions to the World Bank and Fund. However meritorious these proposals may seem in principle, there is no escape from the fact that outlays for them must be financed, if not out of additional taxes, then out of further increases in the public debt.

Another question that must be asked is whether the new contributions to the Fund and the Bank would be a substitute for other forms of United States aid or a net addition. Government grants and loans to foreign countries as well as private capital outflow continue at high levels. Foreign countries as a whole are acquiring, through all their transactions with the United States, much larger amounts of dollars than they are using. As a result of the large cash deficit in its balance of payments, the United States has lost over $2 billion worth of gold so far this year.

Care must be taken in any case not to overburden the capital markets of developed countries. As Mr. Black stressed, "It must not be forgotten that, ultimately it is the savings of the people of the capital exporting countries which is the source from which external capital for the underdeveloped world comes. This source is not limitless; indeed, the demands on it already exceed the supply."

Congress and the American people will have to be convinced, therefore, that further large contributions to the World Fund and Bank will serve the national interest. There may be few difficulties in steering the proposed increase in the Bank's capitalization because the additional capital is needed, fundamentally, as backing for future borrowings in the capital market. But the enlargement of the Fund's resources, which would require a large gold and dollar payment, will undoubtedly give rise to many searching questions. In particular, the American business community will want assurances that a further substantial United States contribution to the Fund will go along with further moves toward meaningful convertibility of the currencies of the principal trading nations.



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